The Manufacturers Hanover
Economic Report

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Quarterly Business Conditions Analysis

Practically since its inception, economics has been known as the dismal science. I don't want to go into great detail about past history, but this appellation has certainly been appropriate in recent years. Scarcely a calendar quarter has gone by in the past two years when a recession was not forecast to begin imminently by one economist or another. Indeed, I have had my share of forecasted downturns that never came.

It is with this in mind that I would hope that the reader will pay careful attention to the analysis I spell out below. For in it I hope to make the case that the near-term outlook is not as gloomy as some forecasters expect. To be sure, I do not believe that the economy will continue to grow at the sizzling 6.5 per cent pace reported for the first quarter. However, neither do I look for the economy to lapse back into recession. Rather, I think that growth will continue — albeit at a more subdued pace. The slowdown will be most pronounced during the current quarter, then economic activity will pick up the beat as the second half gets under way. By yearend, growth may be at its highest point since the opening quarter of 1981 (see table).

Don't Underestimate The Consumer

In preparation for undertaking the quarterly forecasting exercise, I went back and examined our forecasts for the past three years. One thing struck me, and that was an almost consistent underestimation of the strength of the consumer sector. This is no small error, since consumer spending plays a very crucial role in the U.S. economy, accounting for about two-thirds of the gross national product. Clearly, the consumer had to have been in better financial shape than the reported economic statistics indicated.

In trying to determine how much better off people were than we were led to believe, we came upon some sources of buying power that do not show up in the income statistics — but do show up in sales and other numbers when people spend. None of these sources of buying power is new, in the sense that they have not been talked about before. However, it would appear that their cumulative influence on consumer spending habits is beginning to outweigh that of the reported data, causing most econometric models and their users to veer sharply from actual events. Add to this the better financial position that some of the *reported* economic numbers are signaling and I come to the conclusion that, as long as confidence remains bright, people will continue to spend.

That consumer confidence remains strong can be indicated from two recent sources. The Conference Board's regular survey of consumer attitudes shows a distinct brightening in March as optimism over future business and employment prospects changed for the better. In addition, several surveys of public opinion show that people seem to have a very positive impression of President Reagan's economic program, and as long as its chance for passage remains high, their attitudes will be favorable. Ironically, some folks have an attitude toward inflation that, while a reflection of lack of confidence in the Administration's economic program, nevertheless could bolster spending in the near-term. The more people think prices will go up, the sooner they may be tempted to "buy now and avoid paying higher prices later."

The first potential source of buying power that I would like to refer to is the so-called underground economy. Estimated to equal anywhere from one per cent to one-third of the gross national product, the off-the-books economy is universally agreed to be growing rapidly. Whether it is actual cash income that goes unreported, or income derived from bartering one's services for another's, the underground economy clearly contains a sizable pool of buying power. The figures most widely accepted are those that equal ten per cent of the GNP, or some $265 billion. Some of these

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funds may never see the light of day, but even if only two-thirds of them were to enter into the spending stream, they would lift the current rate of personal consumption expenditures by ten per cent.

A lot of negative forecasts have been generated based on low savings as reported in the national income account (NIA) statistics. But these numbers are statistically suspect. What is more, a recent revision in the data revealed that people had been salting away an average of $9 billion more per year than the government previously thought. In addition, NIA statisticians do not consider as savings the repayment of debt, yet it is in a sense because it builds up one's buying power just the same as if one were putting the money in a savings account, certificate of deposit, Treasury bill, etc. The government produces a series that takes this broader concept into account. A part of the Flow of Funds, the savings statistics generated from this source show approximately twice as much savings in the economy as would be suggested by NIA data. What is more, the ratio of Flow of Funds savings to take-home pay has not dropped over the course of the 1970s the way the NIA ratio has.

Unlocking The Increased Value Of Homes

The biggest chunk of potential buying power is the one that is growing the fastest, becoming more and more important to most people, yet is the hardest to get a precise handle on. This is the purchasing power that people have gained through the years as their homes have risen steeply in value because of soaring inflation. We tried to calculate just how much this represents. Taking the median value of owner-occupied housing units and multiplying that by the total number of units as estimated by the Census Bureau produces a gross value of homes approaching $2 trillion at the end of last year. Subtracting from this the approximately $1 trillion in mortgage debt outstanding for these homes reported by the Federal Reserve leaves about $1 trillion in unmortgaged value of housing that could be tapped.

To put this number in perspective, it is the equivalent of 55 per cent of after-tax income, $1.8 trillion, reported by the government for individuals last year. In recent years this figure, the unmortgaged value of homes, has grown even faster than the general price level for goods that consumers purchase. From 1973 through 1979 the personal consumption expenditures deflator rose by about 50 per cent. By contrast the unmortgaged value of owner-occupied housing went up by 150 per cent. This dramatic increase in the "real" value of household equity has proven mighty tempting to consumers — by an increasing amount in recent years.

To document this we traced the trend of mortgage debt outstanding adjusted for inflation compared with housing starts (which are a unit, or "real" figure). We found that, whereas housing starts in 1980 were only 63 per cent of their 1973 levels, real mortgage debt was 20 per cent greater. With more and more articles appearing in personal finance-type publications showing consumers how to "unlock" the increased value of their homes for such purposes as travel, college for the children — and even a car — it stands to reason that this is becoming a more and more important source of income even for those who don't sell their homes. Needless to say, those who do sell find this source of buying power literally dumped into their lap.

Aside from these "unreported" sources of buying power, those that economists have been able to monitor appear to be flashing brighter signs. For one thing, after a modest dip in February, total manhours worked in manufacturing industries rose in March. This helped personal incomes post a larger gain in March than the 0.7 per cent rise in February. When taxes are taken out and an adjustment is made for inflation, total consumer buying power from incomes in the twelve months ending March 1981 was up substantially, after having fallen earlier. (The big slide in personal incomes last year did not get underway until April.)

People Can Borrow—If They Choose

Then there is the use of credit. The old rule of thumb used to be that when repayments on installment debt took 15 per cent or more of take-home pay to service, people would generally be in a financial bind and would have to cut back their expenditures. However, as the 1960s melted into the 1970s, 15 per cent became 16 per cent, then 17 per cent. By the end of the 1970s, people were able to handle installment debt repayments amounting to as much as 18 per cent of take-home pay before finding it necessary to cut back. If one looks at this statistic at face value, one can be moderately optimistic, since it now takes little more than 16 per cent of take-home pay to service installment debt — down from the record of 18¼ per cent set in 1979. However, even this may not be as bad as it looks since more and more installment debt numbers include credit-card buying. Unlike other forms of consumer credit, credit-card debt tends to be paid off relatively quickly, since it reflects a form of convenience buying by people who don't want to carry much cash around. Clearly, as this debt is paid off, new debt can be assumed. Thus more borrowing — hence buying — power may exist than can be discerned by looking at the debt figures alone.

Besides installment debt, mortgage repayments as a percentage of disposable incomes are down, too. In

this case, it is a reflection of the slump in the housing market of the past two years as housing prices and mortgage interest rates soared to stratospheric levels. It is also a reflection of personal incomes growing while existing mortgage debt, in virtually all cases, has remained static. Whatever the reason, and in light of the points I noted above regarding the unmortgaged value of owner-occupied residences, it would appear as though many families might be in a position to take on more mortgage debt — possibly by securing a second mortgage — to finance increased expenditures.

The flip side of this reduced use of debt can be seen in the numbers dealing with the percentage of retail sales made with the help of credit. In 1978 and 1979 almost four out of every ten retail sales dollars were rung up with the help of installment debt. This plunged to little more than 28 per cent a year ago in the wake of the misinterpretation on the part of many people of the Federal Reserve's credit controls program. It has since rebounded — but only to about one-third, suggesting that more intensive use of debt to finance expenditures is possible.

I noted earlier that some people have an attitude towards inflation that is diametrically opposed to that which the Administration is trying to generate. That is — they continue to fear higher prices and are buying ahead of schedule in order to beat them. According to Lyle E. Gramley, a member of the Board of Governors of the Federal Reserve System, "anticipations of inflation are virtually as strong now as they were at their worst early last year." He attributes this to the underlying strength in the economy, noting that the steep but short recession of 1980 had relatively little effect either on the underlying inflation rate or on the public's perception of the outlook for prices.

On the other hand, there are those whose attitudes toward inflation have brightened — either because of the Administration's program and its commitment to lowering the rate of inflation, or in a response to events around them. Specific reference is made to the rebates offered by Detroit, which got people into the marketplace pretty quickly, not to mention the give-backs many unions have proffered in a variety of industries in response to soft labor market conditions.

Business And Government Will Lend A Hand

If and as the consumer increases the pace of spending, business will find it necessary to respond by restocking inventories. The latest reading of the critical inventory-sales ratio taken by the Commerce Department shows that stocks are just a tad above recent record lows relative to sales. While the use of computers and more intensive management techniques have lowered the long term trend of inventories relative to sales, and while the disparate rates of inflation on inventories and sales may make the "nominal" ratio look lower than the "real" ratio, it cannot be denied that inventory levels in many industries are precariously thin. This is the case if only because of the persistent warnings of recession sounded by economists.

In addition to restocking inventories, business will find it expedient to lift spending on new machinery and equipment as the so-called business tax cut works its way through the Congress. Then there is the boost to business attitudes that has already been generated by the Reagan Administration's lifting or canceling of many rules and regulations. On the government side, we have defense spending, which even before the Reagan Administration has had a chance to make its mark felt, is rising at the fastest rate since the Vietnam War. And if the President has his way, it will go up even faster. Needless to say, this sector is affecting prospects for a wide variety of industries in many regions of the country.

Where I come out, then, is on the side of those who acknowledge that the economy may grow more slowly over the next few months — but will not lapse into recession. This is not to say there may not be some down months immediately ahead. Indeed, our projection for the second quarter's average growth rate is so miniscule that it falls within the realm of statistical error as far as a potential minus is concerned. However, any dip should be brief, as long as the economy continues to be supported by the forces I have described above.

Time For Some Optimism

Hopefully, as the year wears on, the economy will regain strength while at the same time inflation and the expectation of inflation will moderate. This belief is based, not only on the Reagan economic plan, but also on such factors as stable energy prices and prospects for good harvests down on the farm. With a little luck we could cross the finish line at yearend with the best of all possible worlds: a rising economy with declining inflation rates and lower interest rates as well.

Given all the things that have gone wrong in recent months, this may seem overly optimistic. However, the time is ripe for a little optimism — especially after all the gloomy forecasts of the past few years. M

April, 1981

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< ACTUAL				PROJECTED >							
	1980		YEAR 1980		1981				YEAR 1981		1982	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2637.3	2730.6	**2626.1**	**8.8**	2826.8	2898.6	2977.2	3066.2	**2942.2**	**12.0**	3158.3	3251.2
GNP: $72	1471.9	1485.6	**1480.7**	**−0.2**	1509.2	1512.8	1520.7	1530.3	**1518.3**	**2.5**	1541.9	1553.8
% Change, Annual Rates	2.4	3.8	**−0.2**		6.5	1.0	2.1	2.5	**2.5**		3.1	3.1
Consumption	1682.2	1751.0	**1672.7**	**10.7**	1805.4	1854.0	1907.9	1959.5	**1881.7**	**12.5**	2010.9	2063.0
Durables	208.8	223.3	**211.9**	**−0.2**	238.1	240.5	250.6	256.1	**246.3**	**16.3**	260.5	265.2
Non-Durables	674.2	703.5	**675.7**	**12.2**	724.4	743.6	760.3	777.3	**751.4**	**11.2**	796.3	814.8
Services	799.2	824.2	**785.2**	**12.8**	842.8	869.9	897.0	926.2	**884.0**	**12.6**	954.0	983.1
Investment	377.1	397.7	**395.3**	**−4.9**	423.1	437.3	450.3	467.9	**444.7**	**12.5**	492.5	518.2
Non-Residential	294.0	302.1	**295.9**	**5.8**	314.7	319.5	327.4	338.2	**324.9**	**9.8**	348.7	361.7
Producers Durable Equipment	186.8	190.7	**187.1**	**2.0**	198.5	201.3	205.2	210.6	**203.9**	**9.0**	216.9	224.9
Structures	107.3	111.5	**108.8**	**13.0**	116.2	118.2	122.1	127.5	**121.0**	**11.2**	131.8	136.8
Residential	99.2	113.0	**105.3**	**−11.2**	116.3	114.4	114.0	118.3	**115.8**	**10.0**	127.0	137.7
Inventory Changes	−16.0	−17.4	**−5.9**		−7.9	3.4	8.9	11.4	**3.9**		16.7	18.8
Net Exports	44.5	23.3	**23.3**		24.3	19.4	18.2	20.2	**20.5**		22.4	23.6
Government Purchases	533.5	558.6	**534.7**	**12.9**	574.1	587.9	600.8	618.6	**595.3**	**11.3**	632.5	646.3
Federal Defense	131.4	141.6	**131.7**	**18.4**	144.9	150.0	154.0	165.2	**153.5**	**16.6**	169.8	174.0
Federal Civilian	63.5	70.4	**67.2**	**18.5**	74.8	75.4	75.1	74.3	**74.9**	**11.5**	75.2	75.6
State & Local	338.6	346.6	**335.8**	**9.8**	354.5	362.5	371.7	379.1	**366.9**	**9.3**	387.5	396.7
Final Sales: $72	1476.9	1492.7	**1483.6**	**0.7**	1515.0	1511.2	1516.7	1525.3	**1517.1**	**2.3**	1534.7	1546.0
% Change, Annual Rates	4.1	4.3	**0.7**		6.1	−1.0	1.5	2.3	**2.3**		2.5	3.0
GNP Price Index (1972 = 100)	179.2	183.8	**177.4**	**9.0**	187.3	191.6	195.8	200.4	**193.8**	**9.2**	204.8	209.2
% Change, Annual Rates	9.2	10.7	**9.0**		7.8	9.5	9.0	9.7	**9.2**		9.2	8.9
PCE Deflator (1972 = 100)	180.7	184.9	**178.9**	**10.2**	188.5	192.7	196.7	200.7	**194.7**	**8.8**	205.3	209.6
% Change, Annual Rates	8.8	9.6	**10.2**		8.0	9.3	8.5	8.5	**8.8**		9.3	8.7
Consumer Price Index (1967 = 100)	249.2	256.9	**247.0**	**13.5**	263.6	270.0	275.9	281.6	**272.8**	**10.5**	286.8	291.7
% Change, Annual Rates	7.8	12.9	**13.5**		10.8	10.1	9.0	8.6	**10.5**		7.6	7.0
Total Personal Income	2182.1	2256.2	**2160.3**	**11.1**	2317.7	2379.3	2453.2	2512.4	**2415.6**	**11.8**	2576.3	2640.7
Disposable Personal Income	1840.6	1897.0	**1821.7**	**11.0**	1945.5	1993.3	2056.0	2134.0	**2032.2**	**11.6**	2185.0	2237.2
Savings Rate	6.1	5.1	**5.6**		4.7	4.5	4.7	5.8	**4.9**		5.6	5.4
Employment Rate	57.5	57.4	**57.7**		57.7	57.7	57.8	58.2	**57.9**		58.5	58.7
Unemployment Rate	7.5	7.5	**7.1**		7.3	7.4	7.5	7.1	**7.3**		7.0	6.9
Indus. Production (1967 = 100)	142.1	149.1	**147.1**	**−3.6**	151.5	151.3	153.1	156.4	**153.1**	**4.1**	159.9	162.6
Housing Starts (000)	1390.0	1534.7	**1303.5**	**−24.0**	1386.0	1304.3	1388.9	1521.0	**1400.0**	**7.4**	1669.4	1792.1
Domestic Auto Sales (000)	6497.0	6668.3	**6643.9**	**−19.3**	7418.0	6836.5	7446.1	7628.4	**7332.2**	**10.4**	7872.9	8071.8
Corporate Pre-Tax Profits	237.6	249.5	**245.5**	**−3.8**	245.6	222.2	226.6	240.1	**233.6**	**−4.8**	240.0	252.2
− Taxes	78.5	85.2	**82.4**	**−6.0**	83.3	75.0	76.7	81.8	**79.2**	**−3.8**	81.4	85.3
Net Profits	159.1	164.3	**163.2**	**−2.7**	162.3	147.1	149.9	158.3	**154.4**	**−5.4**	158.6	167.0
− Dividend Payments	56.7	57.7	**56.0**	**11.7**	59.6	61.5	63.3	65.1	**62.4**	**11.4**	66.9	68.7
Undistributed Profits	102.4	106.6	**107.2**	**−8.9**	102.7	85.6	86.6	93.2	**92.0**	**−14.1**	91.8	98.2
+ Depreciation	160.5	165.4	**158.3**	**13.4**	170.6	202.4	207.6	212.7	**198.3**	**25.3**	231.2	236.9
− Inventory Profits	41.7	48.4	**45.6**	**7.1**	38.4	42.7	41.8	46.1	**42.2**	**−7.5**	48.6	48.6
Net Cash Flow	221.2	223.6	**219.8**	**2.4**	234.9	245.4	252.3	259.8	**248.1**	**12.9**	274.3	286.5

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Where Is It Written?*

The late George Meany is reported to have said that economics is the only profession where a person can gain great eminence without ever being right. The Russian economist, Nikolai Dmitriyevich Kondratieff, wasn't quite as lucky. He was arrested and executed for his theory of the superlong business cycle which apparently contradicted the Communist notion that the capitalist system would decline and inevitably collapse.

Considering the flack economic forecasters have run into in recent years because of their seeming inability to predict the course of economic events, I wonder if people realize that there are no infallible crystal balls — in economics, or anywhere else. What is more, no one ever said that there was.

Nowhere in the standard dictionary definitions of economics and economists is there any reference to forecasting or predicting. The same is true, I might add, of meteorology, an equally abused discipline. Yet, businessmen and governments must look to the future in formulating strategies. And just as people don't stop looking at the weather forecasts in their daily papers simply because the weathermen have been wrong more often than they have been right, people need to know what the economy will be like, and are eager to get opinions, no matter how ill-founded most of them may be.

We All Try To Look Ahead...

The idea of wanting to look ahead is almost as basic as life itself. People forecast all the time without realizing it. When one chooses a career, buys a house, gets married or has a child, one is forecasting that the pluses of those endeavors will outweigh the minuses. When one crosses the street, one makes an implicit forecast that one will not be struck down as one attempts to reach the other side. But it is a long way from this, to the attempts by economists to forecast hundreds of statistics far into the future to five significant numbers.

The early economists were explainers rather than forecasters. They were more interested in learning how the economy operated rather than in predicting its performance. In the 1930s, this analytical process helped develop our national income accounting system, which produces the gross national product statistics that receive so much publicity these days (and which we all try so hard to forecast).

While there may have been some attempts to look ahead as the 1930s wore on, economists did not make forecasting an integral part of their work until after World War II. At that time, there were widespread fears that, without the stimulus of defense spending, the U.S. would lapse back into depression. The Employment Act of 1946 was passed, and the Council of Economic Advisers established as a means of keeping policymakers informed about economic trends and tendencies. But even then the aim was not so much to predict the onset of the next business cycle as to prevent it.

As government grew to depend more on economic analysis, businessmen took notice and began to hire economists, too. From a modest beginning at a few major banks, economists soon landed jobs with companies in virtually all industries in all parts of the country. It didn't take long for both the private and the public sectors to realize that economics could be useful in formulating strategies. However, the evolution of the idea that economists are primarily soothsayers probably was derived more from business and government needs for forecasts than from a desire on the part of economists to adopt that role. Not that we have fared all that badly; there has been a pretty strong job market for economists for quite some time, as Mr. Meany's statement implies.

In the process of crystal ball gazing, many economists have lost sight of what economics is all about. It is a social science concerned with the determinants of the

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ways in which goods and services are produced and exchanged, and with the allocation of the income from production among the various claimants upon it. A specific level of gross national product, employment, inflation or whatever has no particular importance by itself. What is important is the process by which that level evolved, its implications for future improvement in economic well-being and its social and political consequences.

The Reagan Administration has been severely criticized for basing its economic game plan on an economic theory which is not only new, but not susceptible to quantification in the form of an econometric model. However, econometrics, for all of its early billing, has not done any better as a forecasting device than any other method — no matter what theory the model is based on.

Although it is largely used today as a forecasting tool, econometrics originally was developed as a means of attempting to understand the economic process. Using mathematics and modern statistics, econometric models incorporated formulas whose components were variables that characterized different aspects of the economy. Each model attempted to include the appropriate number of variables, and tried to portray their relationship to one another so that by changing one, economists and policymakers might see what would happen to the others.

When model builders attempted to use these for forecasting, they came a cropper for several reasons. For one thing, the data fed into these models were frequently revised. For another, relationships between economic variables, and people's reactions to economic, political and social developments tend to change over time, something that mathematical models, which are based on extrapolating past developments into the future, can not pick up.

Speaking about external developments, there have been so many unusual things that have happened over the past decade that if anybody did manage to forecast correctly, it would have been by the sheerest of coincidences. No economist, perched at the beginning of the last decade, could have anticipated, for example, two freezes and four phases of wage-price controls, the OPEC oil shocks, the resignation of a president and a vice president, not to mention the erratic changes in weather patterns which caused crop failures in many parts of the world and the anchovies to disappear off the coast of Peru!

...But Economists Should Analyze More

Before I am ostracized from the profession altogether, let me observe that economists still have an important role to play. However, less emphasis ought to be placed on forecasting and more on explaining. By this I mean that since most of us do keep our fingers on the pulse of the economy, our views of current events and the possible implications of social, economic and political behavior would seem to be useful. The same would seem to be the case for our assessments of the effects of various economic policies that might be under consideration at a given time.

As long as they keep in mind that the "real world" changes constantly — including the fact that people are becoming more and more sophisticated about economics and tend to react to forecasts in ways which can cause them either to come true or to be wrong — economists will be performing a useful service. As for forecasting, a good rule of thumb is to remember the advice given by the late Professor Marcus Nadler: "If you have to forecast, do it frequently." ■

The EMS: A System Under Stress

The European Monetary System (EMS) was established in March, 1979 to create a "zone of monetary stability" among the currencies of the members of the European Economic Community (EEC). Eight of the nine members of the EEC joined the EMS. The United Kingdom opted to stay outside this system. The intent of the EMS was to reduce the volatility of the foreign exchange rates between the member currencies, which is characteristic of a floating exchange rate system, and to regain some of the advantages of the fixed rate system which came to an end in the early 1970s. Among these are the ability to undertake long-term investments with less uncertainty about future costs and benefits and to improve trading relationships through price stability. Further, it was hoped that the EMS would eventually lead to a convergence of economic policies and performance among members — and eventually to a common EEC currency.

The essence of the EMS is coordination and cooperation, both explicitly and implicitly. Explicitly, members are called upon to maintain the parity relationships within a relatively narrow band — 2.25 per cent on either side of the central rate for the currencies of Belgium, Denmark, France, Germany, Ireland, Luxembourg and the Netherlands and six per cent for Italy. Intervention in the exchange market to maintain these relationships is obligatory for any member whose currency threatens to go beyond the band. Implicitly, member countries are expected to modify their economic policies whenever an established "divergence threshold" is reached, indicating a fundamental shift in economic relationships; either a longer term strengthening or weakening of a member's economy against the others. This further implies a move toward

a convergence of economic policies of all members. It is this latter goal which creates the greatest difficulties for the system and may be the cause of its ultimate disintegration or fundamental modification. In practice, when the divergence threshold has been reached, the EMS has opted to adjust the central parities rather than demand that a member undergo the rigors of fundamental policy adjustments. This, of course, defeats the purpose of fixed rates.

Essentially, the EMS is an agreement of eight national economies to move forward together at the same rate. It is analogous to a company of soldiers marching in step, moving at the same pace and in the same direction in spite of the fact that some of the soldiers may be very tall and others very short. The difference is that the common purpose and controlling discipline of a military unit does not yet exist in the EMS. Fixed exchange rates require that the member countries maintain uniform rates of economic growth, inflation, interest rates and external balances.

Although there is some room for variances in any one of these interrelated economic factors by compensating in another one, the structure of the system does not allow for wide variations over an extended period of time. Since purchasing power is the ultimate criterion for exchange rate relationships, purchasing power parity eventually will determine exchange rates, and this requires a convergence or, at least, a fixed relationship between economic policies and performance of the member countries.

Internal Stresses...

Since the inception of the EMS, there have been wide variations in the economic performance of the member countries. The following table illustrates these discrepancies based on the available data for 1980:

ECONOMIC PERFORMANCE IN 1980

Country	Real GNP Growth (%)	Consumer Prices (% Yr/Yr)	Current Account Balance ($ billions)
Belg./Lux.	1.0 (est.)	6.7	– 4.7 (IIIQ, 1980)
Denmark	– 0.7	12.3	– 2.5
France	1.2	13.3	– 7.3
Germany	1.8	5.5	– 15.8
Ireland	1.0	18.2	– 1.2
Netherlands	1.2	6.5	– 2.4
Italy	4.0	21.2	– 9.9

How does divergence in economic performance affect exchange rates? Inflation diminishes purchasing power and the real return on investment. Investment then flows toward countries with lower rates of inflation where the "real" return (interest rates minus the rate of inflation) is greater. This simultaneously creates a demand for the currency of the country with lower inflation and reduces demand for the more inflated currency. In order to reverse these financial flows, interest rates are raised to the point where the real interest rate is equal to or greater than those in the country with the lower inflation rate. This may in turn create a competitive interest rate race. As real interest rates rise, economic growth tends to decline.

Inflation also affects trade. As a country's domestic inflation increases, imports are temporarily cheaper (until exchange rates adjust), stimulating the purchase of imported goods. The demand for foreign currency increases to pay for these imports and the supply of the purchaser's currency on the exchange market increases and thus cheapens. This, too, leads to a divergence of exchange rates. Since a current account deficit represents the difference between a nation's exports and imports of goods and services, such a deficit also represents the net outflow of trade related funds. A current account deficit increases the supply of funds in the foreign exchange market. All of these factors tend to cause the exchange rates between countries with differing economic performance to diverge. It is apparent, then, from a consideration of the table that pressures toward divergence are already great and will increase if the divergence in economic performance increases.

This would appear to argue for a greater uniformity of economic policies if the members of the EMS wish it to remain intact. But differing political, economic and social goals generate differing policy responses. In one country, controlling inflation may take priority over reducing unemployment. In another, exports may play a greater role in economic activity. Elsewhere a comprehensive and pervasive social welfare system may divert financial resources to the state, creating budget deficits which raise inflation and interest rates.

...And External Strains

Not all of the stresses on the EMS are internal. The originators of the system had hoped that by creating a zone of monetary stability they would insulate their currencies from the effects of external volatility and instability introduced by other currencies, particularly the dollar. In fact, the influence of the dollar has been magnified in some respects. Since the currencies of the EMS member countries are tied together in a matrix of more or less rigid parities a strong appreciation or depreciation of any one of these currencies against the dollar pulls the others along with it without regard for the bilateral economic relationships of each country with the U.S.

The larger the economy which is moving against the dollar, the more irresistible the pressure. Since the West German economy is the largest and the strongest in the EMS, if economic trends in that country move differently than in the U.S., causing the DM to fall or rise against the dollar, the impact on other

members is enormous. In 1979, as the German mark gained strength against the dollar, the other EMS countries also found their currencies strengthening against the dollar, too, in spite of the fact that in many cases this priced their exports out of U.S. (and other dollar denominated) markets, and encouraged imports causing their trade and current accounts to go into deficit. At the same time, since the bulk of their trade was with other EMS countries, they were deriving no particular compensatory trade advantages since the parities among them remained roughly the same. Some benefit was derived, however, because oil imports, paid for in dollars, became cheaper.

Conversely, as the DM has weakened against the dollar, EMS exchange rates have been pulled down, increasing the cost of dollar denominated imports. To the degree that an EMS country's trade is transacted in non-EMS currencies, particularly the dollar, there will be pressure on its exchange rate to diverge from its EMS parities. These pressures on the system have been recognized and mechanisms have been developed to deal with them. But they are largely short term, buying time for longer-term adjustment through a convergence of economic policies. Although the shorter-term adjustment features of the EMS have worked in the past and continue to work, there has been virtually no progress toward unified economic policies.

The short-term adjustment mechanism is intervention in the foreign exchange market by any EMS member country whose exchange rate threatens to move outside of the permitted limits from the central parity rate with another EMS currency. That country must either buy or sell in the market to restore equilibrium. If, for example, the DM strengthens against the Belgian franc, the German central bank will sell DMs and buy francs until the balance is restored. At times of great stress in the system, the amounts involved in such intervention have been huge. Further, intervention can not be isolated from its effects on domestic money supply. Large scale intervention introduces severe distortions into domestic monetary policies. The response to these sudden jumps in money supply is frequently a tightening of credit availability to reduce the inflationary impact. Thus, intervention transfers instability from exchange rates to interest rates.

Two years is too short a time to come to a firm conclusion about the long-term viability of the EMS. It has survived remarkable stresses and strains in that time. Recently, European currencies have plunged against the dollar. Italy and Germany are in recession while interest rates in the United States have drained funds from Europe and diminished the value of their financial assets. The burden of sustaining the EMS falls most heavily on the larger economies, particularly the German and French. How long will it be in their interest to maintain it? The EMS was the brainchild of President Giscard d'Estaing and Chancellor Schmidt. One is now leaving the scene, and the other presides over a troubled economy deeply riven by political and economic conflicts.

Commitment to the EMS may weaken if it conflicts with domestic demands. In spite of adherence to the principles of the EMS, each member country is, in the last analysis, governed by what it perceives to be in its own best interest at any given time. But, it is less a question of whether the EMS will survive than how it will maintain the zone of relative monetary stability to which it is dedicated. Finally, the goal of unifying the disparate economic policies of the EMS nations remains as far from realization today as it was at the system's inception.

—William L. K. Schwarz, Vice President

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MANUFACTURERS HANOVER

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7/24/81

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JUNE 1981

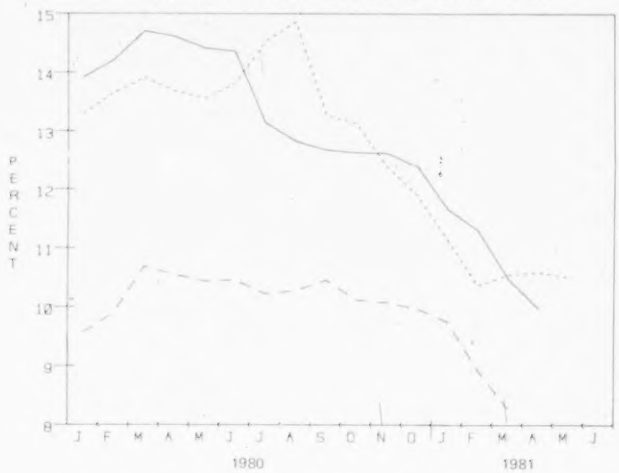
The Meaning Of Less Inflation

This may surprise you, but for all the rhetoric you hear these days about the need to reduce the rate of inflation, we have already done so—and to a significant extent. No matter which index you look at—consumer price index (CPI), producer price index (PPI), personal consumption expenditures index (PCE), or the various indexes of basic commodities' prices, inflation has cooled considerably from the overheated pace of early 1980. What is more, since virtually none of this improvement can be ascribed to any act of the Reagan Administration, it is very likely that further progress is in store, since reducing inflation is plainly Washington's number one priority.

The notion then comes to mind that this curbing of inflation could result in some rather interesting side effects. Because of the high rate of inflation that we in the United States have experienced in recent years, many businesses, households and individuals have made decisions in the belief that inflation would continue. Some have come to this conclusion involuntarily, figuring that there was no use in fighting higher prices. Others, seeing their incomes rise with inflation, have been less unwilling to accept it. Still others have learned to benefit from inflation; these people look forward to its continuation. Whatever the case, the slowing of inflation that has already occurred—not to mention what lies ahead—calls for a reexamination of many people's beliefs, buying habits, investment and business decisions.

As you can see from the chart, the rate of inflation has slowed dramatically since the beginning of 1980. The PCE index is up 8.3 per cent compared with nearly 11 per cent in the twelve months ending March 1980. For its part, the CPI has risen by about 10 per cent in the last twelve months, down from 15 per cent in the year ending March 1980. And the PPI's twelve month percentage change is 10½ per cent, down from 14 per cent in March a year ago. None of this slowing is due to anything that the President can take credit for,

12 MONTH PERCENT CHANGE IN CONSUMER PRICE INDEX (LINE), PRODUCER PRICE INDEX (DOT), PCE DEFLATOR (DASH)



since the Reagan Administration has been in office about five months and any policies enacted to slow inflation clearly require a longer period of time to have a positive impact. (Ironically, the President has managed to influence prices *negatively* by releasing gasoline and oil prices from domestic controls, thus causing them to jump earlier this year. But to the extent that higher prices have encouraged conservation, they may yet prove to be a positive factor by keeping usage so far below production that prices will soon come down.)

Many Have Accepted Inflation . . .

Those who have accepted inflation involuntarily will have no problem with its slowing. In actual fact, no one *likes* to pay more for something, [illegible]se of us who look only at this aspect of inflatio[illegible] not be disappointed by its departure. However, a number of people have begun to accept inflation as a way of life.

You don't have to look far to find people who have accepted inflation. The first group that comes to mind is those whose incomes are linked formally to the consumer price index. Known as indexing, this is a system by which wages, pensions, welfare benefits and other types of income are adjusted automatically for inflation—usually as measured by the consumer price

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index. Thus, as the CPI advances, so does the income linked to it. Since the CPI is generally acknowledged to overstate inflation, actual buying power of those whose incomes are linked to the CPI has risen. Among the largest and best known groups of recipients of indexed income are those on Social Security. Last July, Social Security recipients received a 14.3 per cent increase in their benefits based on a similar rise in the CPI some months earlier. Besides Social Security beneficiaries, retired government workers' pensions are indexed to the CPI, as are those of persons receiving food stamps and disability payments. Indeed, according to the 1981 budget estimates, 42 per cent of all government outlays will go to programs whose benefits are indexed.

Of course, indexing is widespread in the private sector. Indeed, it was a union in the private sector, the United Auto Workers, which in 1948 negotiated the first labor contract that included a cost-of-living adjustment (COLA). COLA clauses were slow to catch on, but by 1965 an estimated 26 per cent of unionized employees were covered by such agreements; the percentage has climbed to nearly 60 per cent today. Ironically, now that inflation is abating, those COLA clauses will help to slow it further, since they will call for smaller increments, thus holding down costs in both the public and private sectors. Non-union workers have kept up with inflation, too. Either because of the COLA clauses that union workers receive, or because of the general awareness of inflation, those who don't get automatic adjustments in pay tend to receive pay raises linked to inflation on an informal basis. I would bet, for example, that most white-collar workers have received a cost-of-living adjustment in their salaries over the past year or two —whether it was called that or not.

. . . Some Need It . . .

As large as this group sounds, it is only the tip of the iceberg, when it comes to people who have learned to live with inflation. Having looked at labor, let us examine management. Inflation has helped management in many ways. For one thing, it allows businessmen to raise their prices without losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are stable. Naturally, inflation boosts the dollar value of sales and earnings thus making many a manager look good—at least on the surface.

Many contracts are signed in the expectation that inflation will benefit one party or the other. Either the terms of the contract are adjusted upward in conjunction with whatever increase occurs in the consumer price index or the spread between the cost of materials in the finished product can be expected to widen as the price level in general goes up. Many businessmen look to inflation as a cushion, in that they can pass along increases in costs more readily in an inflationary environment than in an era of price stability.

Certainly the real estate market has come to terms with inflation. Landlords have long since inserted COLA clauses in leases, while a great many people have bought properties with only the smallest of down payments and the longest of mortgages that can be obtained, thus becoming highly leveraged. Plainly, these people are counting on inflation to continue, so that the increase in prices and incomes will ensure that they will be able to pay off their mortgages with cheaper dollars. A growing number of individuals have become involved in real estate, buying not just one house to live in, but additional houses and apartments in the belief that real estate is an unbeatable investment whose value will not only keep up with inflation —but exceed it.

Because mortgage rates got so high that many people could not even buy their first house, a number of lending institutions have developed new ways of helping people finance the purchase of a home. Taking their cue from the equity-kicker concept used in commercial real estate and corporate finance, some savings and loan associations have developed a concept known as shared-appreciation mortgages (SAMs). These recently became sanctioned by the Federal Home Loan Bank Board, which regulates Federally chartered and insured S & Ls. These equity-participation mortgage loans permit the homebuyer to obtain a below-market interest rate, in return for which the lender collects a share of the home's appreciation after a stated number of years, or when the mortgage is paid off through sale of the property.

Borrowers in general have not only learned to accept inflation, many even like it as well. In a period of inflation, borrowers come out ahead for several reasons. The first is that the loan is paid back with cheaper dollars—the longer the term of the loan the cheaper the dollars so long as inflation continues to erode the buying power of the buck. For another, since borrowing permits one to buy something sooner than would otherwise be the case had one waited until one saved enough money to afford the purchase, one is ahead in a period of inflation because buying sooner rather than later beats higher prices. Finally, a borrower can deduct the interest cost of obtaining the loan from one's tax return, thereby reducing taxable income.

It may surprise you to learn that lenders have a stake in inflation, too. For one thing, inflation has bailed out many a bad loan—especially in the real estate area. Indeed, continuing inflation makes it easier for borrowers to obtain the funds to repay their loans, thus helping many a lending officer sleep better at night. (Of course, if lending officers were to consider the buying power of the dollars they were getting back, they might have a nightmare or two.) To protect them-

selves from the negative aspects of inflation, lenders have been making loans with interest rates that float. Long a factor in the market for short-term loans, variable rates have recently become common in the longer-term markets. Last November, a major finance company sold to the public $250 million worth of ten-year debt with an adjustable interest rate tied to the rate on ten-year Treasury securities. Several insurance companies have begun asking floating rates on the funds they deploy for even longer periods.

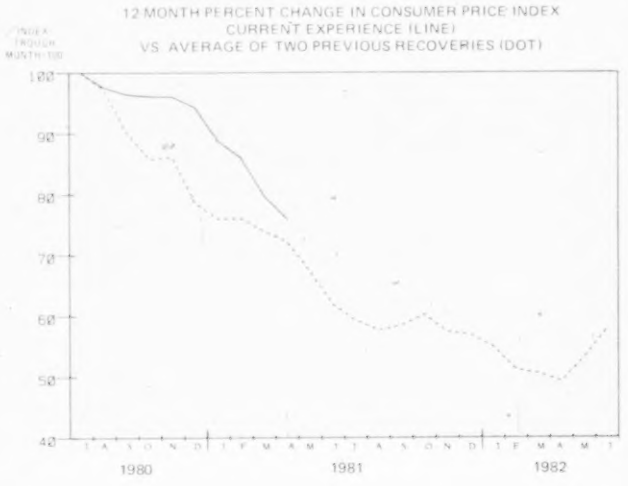
In the short-term market, where floating rate loans have been common for some time, the rate that borrowers pay is linked to either the banks' prime rate, or a money-market rate. Since inflation raises the banks' non-interest operating costs, they must lend increased numbers of dollars, if they are to spread these rising operating costs over a larger volume. Thus even the banks are not disinterested in inflation. Apparently, people are no longer heeding the warning in Hamlet: "Neither a borrower nor a lender be."

If borrowers and lenders have learned to live with inflation, what about savers? No problem here; they have adjusted to inflation, too. Because of inflation, high interest rates are available for savers through the purchase of such money market instruments as Treasury bills, certificates of deposit, and more recently, money market mutual funds. Thus while inflation may erode some peoples' savings, others at the same time have been able to enjoy the fruits of inflation in the form of much higher interest rates than they otherwise could get. Then there are those who collect commodities of one sort or another. By these I mean stamps, antiques, jewelry, works of art, ceramics, Persian rugs, and so forth. I wonder how many of these collectors bought these objects for their beauty alone as opposed to what they think their worth will be in months and years to come. And if these collectibles were purchased with borrowed funds, their buyers would have an even greater stake in seeing inflation continue for reasons I have already noted.

One group with an interest in inflation is our elected officials. Under inflation, politicians can make more promises than they know will be kept in real terms. This is because they can promise to spend certain amounts of dollars on various projects, benefits etc., knowing that by the time they are spent, these dollars will not buy what their constituents think they will. In addition, thanks to our "progressive" tax structure, inflation pushes people into higher tax brackets, increasing the revenues that Washington (and some states) gets from income taxes. This, too, benefits politicians, for it gives them more money to spend. On the local scene, politicians benefit additionally from inflation because higher prices on goods and services mean more sales taxes will be collected without there necessarily being an expansion in the real volume of transactions.

. . . But New Strategies Are Called For

The message is clear. Since inflation has already wound down to a considerable extent and should retreat even further over the coming year, if only because of the normal improvement in inflation in the two years or so following the end of a recession (see chart), not to mention the determination of the Reagan Administration to bring inflation lower, people would be wise to start adjusting to these new "facts of life." Those who bet on continued high rates of inflation will lose, while those who are counting on greater price stability will come out ahead. For example, workers who demand big wage increases in the expectation that their employers can pass along the higher cost may well find themselves without work. By the same token, those employers who blithely accept higher wage (and other) costs with the same belief may find that they are unable to pass them along because less inflation is the order of the day and their price increases will stand out more.



People had better be cautious, when it comes to the purchase or sale of real estate. Too much leverage might not be advisable in an era of less inflation, as far as borrowers are concerned. Lenders should scrutinize the loans they make more carefully, and those who give up some immediate returns for the promise of future returns linked to inflation may be equally as disappointed. COLA clauses may prove less rewarding. As inflation continues to recede, those investors who do not lock in today's high interest rates could well be missing what will be a golden opportunity, since less inflation usually means lower interest rates.

Since virtually everyone will be affected by the reduced inflation environment, it would seem wise to adjust now rather than later. In so doing you will minimize the consequences of the return to price stability, while at the same time you might be able to take advantage of some of the distortions that still prevail as a legacy from the high inflation environment of the past.

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8/3/81

The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

JULY 1981

Quarterly Business Conditions Analysis

The drop in economic activity in the second quarter has produced fears that the economy may have entered into a new recession. This is particularly ironic because the umpire of the business cycle, the National Bureau of Economic Research (NBER), has just decided that the 1980 recession came to an end last July and was the shortest on record. If the GNP continues to fall, the recovery that the Bureau says got under way in August, 1980 could also turn out to have been the shortest on record.

This apparent telescoping of the business cycle raises some questions. According to the NBER, the 1980 recession was only half as long as the one-year average recession of the postwar era. And if the ensuing recovery lasted also about six months, it would not only be the shortest on record—but less than one-sixth the length of the average postwar peacetime expansion. Indeed, you would have to go back to the expansion of 1912-1913 before finding anything remotely as short as six months—and that one lasted one year.

Are The Recession Dates Wrong?

At this time, I would like to propose that the NBER reconsider the starting and ending dates for the 1980 recession. To many consumers and businessmen in the "real world," the recession really got under way in 1979—and is still with us. While the real gross national product did advance in 1979, practically all of the rise occurred in that year's first quarter. The real GNP rose 3.2 per cent in 1979 over 1978—but the first quarter's rate alone was three per cent higher than 1978. The real GNP virtually flattened after that—not at all dissimilar to the flatness that characterized 1974, which the NBER counted as part of the 1973-75 recession.

As for changing the terminal date, I would observe that, in spite of first-quarter 1981's 8½ per cent jump in the real GNP, the economy today has risen at an annual rate of only one per cent since the beginning of 1979. By contrast, in the preceding nine quarters, the GNP grew at a four per cent clip. This kind of performance is unlikely to change any time soon. The reason for today's softness in economic activity may be different from the past, but the end result is the same. Strikes, bad weather, reduced energy supplies, soaring inflation, speculation and credit controls have now been replaced by tight money and high real interest rates which are unlikely to abate any time soon. As a result, the economy is likely to perform below par for several more quarters at the very least, as a growing number of industries experience sales and output declines with consequent squeezes on earnings and drops in employment.

Several observers have made the point that the U.S. economy has become highly segmented. That is—it no longer moves as a monolith, with all industries expanding during good times and contracting during bad times. Rather, it has split into different sectors, some immune to the effects of the business cycle while others seem unable to escape it.

Looking beneath the surface, this seems to make a lot of sense. Such key industries as automobiles and housing have long evidenced a sensitivity to changes in business and financial conditions. That is—they would be among the first to decline when interest rates rose and money tightened sending the economy into a downturn, but would revive with equal vigor when these conditions reversed. In the last two years, however, both autos and housing have been severely depressed. After averaging 9.2 million units in 1977 and 1978, sales of new domestic passenger cars fell to 8.3 million units in 1979—then plunged to 6.6 million units in 1980. The selling rate so far this year is 6.5 million units. However, sales have weakened in recent months; second-quarter new-car sales amounted to an annual rate of 5.6 million units. And in

NO REPORT IN AUGUST

The monthly economic report will not be published during August. The next issue will appear in September.

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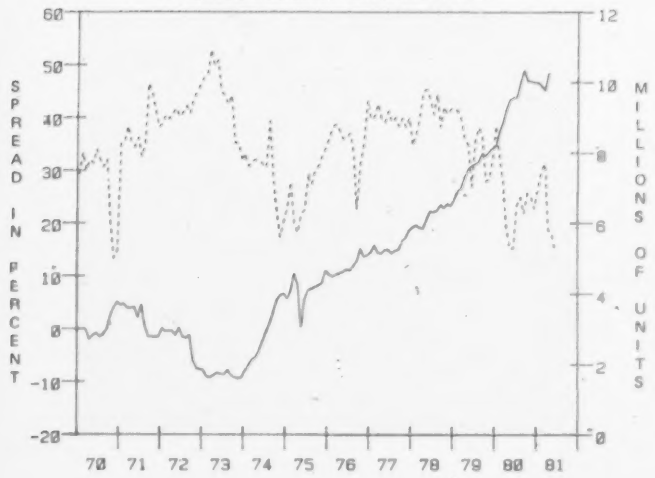
the last ten days of June and the first ten days of July the selling rate slumped to 4.8 million units. With the exception of the General Motors strike in fourth-quarter 1970, this was the lowest selling rate for new domestic-model automobiles for any 20-day period in at least two decades.

Unquestionably, high interest rates have played a part in the auto industry's slump. Not only have dealers been reluctant to stock cars with interest rates adding so much to their costs, but consumers have been reluctant to buy for the same reason. Autos also have been hurt by their rapid run-up in prices. As you can see from the chart, new-car prices have gone up much faster than buying power in recent years, and this clearly has had a negative impact on sales.

SPREAD BETWEEN RISE IN NEW CAR PRICES AND GROWTH IN REAL PER CAPITA DISPOSABLE INCOME (LINE) SINCE JAN. 1970 VS. NEW DOMESTIC CAR SALES (DOT)



For housing, whose prices also have outpaced incomes, it appears to be more a question of availability and price of money than cost of the home. This is because, in contrast to automobiles and most other goods, prices of used or existing homes have gone *up* over the years, thereby overcoming the deterrent of higher new-home purchase prices. That is to say—people look upon the purchase of a home as an investment, one whose value has kept up with, if not exceeded the overall rate of inflation. Still, new-home construction has slumped. After averaging two million units in 1977 and 1978, new private housing starts dropped 13 per cent to 1.7 million units in 1979—then tumbled another 26 per cent to 1.3 million units in 1980. They have been bumping along at this rate so far in 1981.

Not surprisingly, the prolonged slump in autos and housing has affected a number of industries whose fortunes are tied to them. Steel output has dropped by about seven per cent since last November, production of rubber tires is no higher than it was almost two years ago, while output of building materials and household goods is down by nine per cent and five per cent respectively over the past two years. Since production of automobiles and the materials that go into them tends to be concentrated in the North central part of the United States, the economies of such states as Michigan, Ohio and Pennsylvania have been more affected than the national average. This is also having a rippling effect on a growing number of industries, since many suppliers tend to be small businesses who are not only affected by autos and housing, but also by the effect high interest rates have on their own financing costs.

Pluses And Minuses.

It was the minuses outweighing the pluses that caused the real GNP to drop in the second quarter. One of the pluses is defense. Although output of defense and space equipment has barely returned to 1967 levels, the increase over the past 3½ years has been substantial. In real terms, after adjusting for inflation, production of defense and space equipment has risen at an average annual rate of about 7½ per cent. Even faster growth seems likely, in view of the sharp jump in unfilled orders for defense products, prime contract awards—not to mention the Reagan Administration's determination to boost defense outlays even faster.

Another sector that seems to be strong is energy. Although energy output has declined over the past year, this largely has been due to the combination of last year's decline in the economy and conservation of petroleum-based energy in reaction to earlier jumps in oil prices. But the energy industry also consists of those firms that are involved in the finding, processing, distribution and improved efficiency of energy and this sector is growing very nicely. This latter group could be expanded to include technology in general. Thus producers of computers, controls and instruments of various types as reporting nice gains in sales and earnings, as businessmen try to cope with the high cost of energy by using it more efficiently and by substituting telecommunications for the physical movement of people.

Exports are helping—so far. As the table on the back shows, net exports as measured in the GNP accounts remain in comfortable surplus. This reflects the earlier weakness of the dollar and the earlier booms in overseas economies—both of which have since disappeared. Also mixed in nature are the capital goods industries. Production of business equipment in the past half year has gone up more than three times as fast as total output, but new orders for nondefense capital goods have fallen 3½ per cent between January and May of this year, suggesting some hesitation about the future.

I am looking for more negatives than positives over the next few months. This is because I believe that the interest-sensitive industries will continue to be weaker than the non-interest sensitive sectors will be strong. In today's context, I would ascribe this to the kind of economic policy that is being administered by Washington. The government continues to be a significant drainer of funds from the money and capital markets. Washington's on-and-off budget financing is likely to total $135 billion in this fiscal year compared with $119 billion in fiscal year 1980. At the same time the Federal Reserve is committed to keeping the growth of money and credit aggregates to an annual rate far below the likely rate of rise of nominal GNP. Since the government gets first crack at the pool of funds available for borrowing, the private sector has to scramble for the rest, and those that are most sensitive to higher interest rates or have relatively difficult access to money are those that will suffer.

Although the combination of a loose fiscal policy and a tight monetary policy will prevent the private sector from mounting a healthy recovery, any declines that surface in the aggregate data should be relatively small. For one thing, I don't anticipate any form of artificial credit constraint in the marketplace. Recent steep declines in economic activity have traced in one way or another to what has come to be known as a "credit crunch," where money is suddenly unavailable regardless of its price.

Last year's steep drop in the economy was due to just such a development. The Federal Reserve's credit controls of last year were largely interpreted to mean that credit was not available for most consumers and businessmen. This led to a sudden drop in credit usage and a concomitant decline in sales of those products heavily dependent on credit. The previous business cycle, in 1973-1975, also traced in part to a credit squeeze as banks were pressured by Washington to charge less for loans than it was costing them to raise funds in the money markets. Quite naturally, many banks became reluctant to make new loans under these circumstances. The 1970 recession traced to a sudden disappearance of individuals and companies willing to invest in corporate commercial paper, producing crunch-like effects as well. And, of course, who can forget the first modern credit crunch that took place in 1966? Then, interest rates moved above the ceilings that banks were allowed to pay for certificates of deposit thus depriving them of funds to lend to their customers.

Besides the absence of a credit crunch, consumers continue to be in good shape financially. The misinterpretation of last year's credit controls caused a cutback in consumers' use of credit, which many have not restored to this day. This not only goes for installment debt, but for mortgage debt as well. Speaking of mortgage debt, there is the increased value of homes that people can monetize. And while total employment dropped a bit in June, the employment-population ratio remains at 59 per cent, only slightly below the all-time record set in 1979. With so many people at work, it follows that incomes are continuing to rise. The fact that inflation has already slowed to the single-digit zone and is likely to decelerate further will help boost buying power in the months ahead.

Another argument in favor of a mild decline is the state of business inventories. Even though there was a jump in stockpiling in the second quarter, businessmen have kept a close watch on inventories for the last couple of years. This is not surprising when you consider the repeated warnings of recession emanating from their economists and, more recently, the high interest rates which have made stockpiling extremely expensive. Whether you look at them in current dollars or in real terms, inventories relative to sales remain well below year-ago levels. That being the case, any further softening of sales would require a smaller adjustment in production than might have been the case had inventories been high. Finally, those sectors of the economy that are still strong are likely to continue so, since they are either less sensitive to the availability of money and its cost, or are responding to longer-run, non-cyclical considerations.

The Outlook Is Bleak.

Before you become too sanguine over the situation, remember that this kind of zigzag economy that we have experienced since early 1979 could very well continue beyond yearend. That is—we might be subject to one or two quarters' worth of growth followed by one or two quarters' worth of stagnation or economic decline for the next few years. To become complacent about this situation is to write off autos, housing and other similarly-affected industries —something I know we are not prepared to do. Yet the alternative is not for the Federal Reserve to loosen credit in order to bring interest rates down and make funds more available for the purchase of these key hardgoods. This is because such a development would only be temporary and would be followed by even higher rates of interest as inflation psychology reached a new higher level. Rather, the alternative must be a tightening of fiscal policy.

The Reagan Administration must examine its spending and taxing policies very carefully with the aim of bringing down the budget deficit as soon as possible so that Washington will not continue to drain strength from the private sector through its huge financing requirements. The financial community does not doubt the Administration's intentions to do so: It only questions whether this can be achieved by boosting defense spending and cutting taxes while barely holding the line on nondefense outlays. H

July, 1981
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< ACTUAL				PROJECTED >							
	1980		YEAR 1980		1981				YEAR 1981		1982	
	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II
Gross National Product	2637.3	2730.6	**2626.1**	**8.8**	2853.0	2881.0	2927.0	2999.4	**2915.1**	**11.0**	3066.0	3146.8
GNP: $72	1471.9	1485.6	**1480.7**	**−0.2**	1516.4	1509.1	1508.6	1517.1	**1512.8**	**2.2**	1522.3	1535.9
% Change, Annual Rates	2.4	3.8	**−0.2**		8.6	−1.9	−0.1	2.3	**2.2**		1.4	3.6
Consumption	1682.2	1751.0	**1672.7**	**10.7**	1810.1	1830.3	1871.1	1917.7	**1857.3**	**11.0**	1963.4	2017.4
Durables	208.8	223.3	**211.9**	**−0.2**	238.3	226.7	233.2	245.7	**236.0**	**11.4**	250.3	262.2
Non-Durables	674.2	703.5	**675.7**	**12.2**	726.0	732.7	744.0	759.1	**740.4**	**9.6**	773.4	789.4
Services	799.2	824.2	**785.2**	**12.8**	845.8	870.9	893.8	912.9	**880.9**	**12.2**	939.6	965.8
Investment	377.1	397.7	**395.3**	**−4.9**	437.1	453.8	439.2	451.6	**445.4**	**12.7**	464.7	480.1
Non-Residential	294.0	302.1	**295.9**	**5.8**	315.9	322.0	324.9	332.0	**323.7**	**9.4**	341.8	344.1
Producers Durable Equipment	186.8	190.7	**187.1**	**2.0**	198.7	201.1	203.7	207.8	**202.8**	**8.4**	212.8	214.9
Structures	107.3	111.5	**108.8**	**13.0**	117.2	120.9	121.2	124.1	**120.9**	**11.1**	129.0	129.2
Residential	99.2	113.0	**105.3**	**−11.2**	116.7	111.4	107.2	104.8	**110.0**	**4.5**	112.9	123.1
Inventory Changes	−16.0	−17.4	**−5.9**		4.5	20.4	7.1	14.8	**11.7**		10.0	12.8
Net Exports	44.5	23.3	**23.3**		29.2	19.4	24.7	22.6	**24.0**		17.2	16.0
Government Purchases	533.5	558.6	**534.7**	**12.9**	576.5	577.6	592.0	607.6	**588.4**	**10.0**	620.7	633.3
Federal Defense	131.4	141.6	**131.7**	**18.4**	145.2	148.1	155.2	164.5	**153.3**	**16.4**	169.0	173.0
Federal Civilian	63.5	70.4	**67.2**	**18.5**	76.4	71.4	70.7	70.5	**72.3**	**7.5**	71.6	72.9
State & Local	338.6	346.6	**335.8**	**9.8**	354.9	358.1	366.1	372.6	**362.9**	**8.1**	380.1	387.4
Final Sales: $72	1476.9	1492.7	**1483.6**	**0.7**	1517.8	1499.4	1505.5	1510.6	**1508.3**	**1.7**	1518.1	1530.6
% Change, Annual Rates	4.1	4.3	**0.7**		6.9	−4.8	1.6	1.4	**1.7**		2.0	3.3
GNP Price Index (1972 = 100)	179.2	183.8	**177.4**	**9.0**	188.1	190.9	194.0	197.7	**192.7**	**8.6**	201.4	204.9
% Change, Annual Rates	9.2	10.7	**9.0**		9.8	6.0	6.7	7.8	**8.6**		7.7	7.1
PCE Deflator (1972 = 100)	180.7	184.9	**178.9**	**10.2**	188.5	191.5	194.2	197.4	**192.9**	**7.8**	201.2	204.6
% Change, Annual Rates	8.8	9.6	**10.2**		8.0	6.5	5.7	6.8	**7.8**		8.0	6.9
Consumer Price Index (1967 = 100)	249.2	256.9	**247.0**	**13.5**	263.6	268.4	273.7	278.3	**271.0**	**9.7**	282.8	287.9
% Change, Annual Rates	7.8	12.9	**13.5**		10.8	7.5	8.0	6.9	**9.7**		6.7	7.3
Total Personal Income	2182.1	2256.4	**2160.3**	**11.1**	2319.7	2367.8	2413.4	2464.0	**2391.2**	**10.7**	2517.8	2572.9
Disposable Personal Income	1840.6	1897.0	**1821.7**	**11.0**	1947.8	1985.4	2024.3	2078.2	**2008.9**	**10.3**	2122.2	2164.7
Savings Rate	6.1	5.1	**5.6**		4.6	5.3	5.1	5.3	**5.1**		5.0	4.3
Employment Rate	57.5	57.4	**57.7**		57.7	58.0	58.0	58.0	**57.9**		58.2	58.3
Unemployment Rate	7.5	7.5	**7.1**		7.3	7.4	7.6	7.7	**7.5**		7.5	7.4
Indus. Production (1967 = 100)	142.1	149.1	**147.1**	**−3.6**	151.8	152.6	151.7	153.6	**152.4**	**3.6**	154.7	155.9
Housing Starts (000)	1390.0	1534.7	**1303.5**	**−24.0**	1390.7	1174.3	1008.6	1163.0	**1184.1**	**−9.2**	1238.8	1429.8
Domestic Auto Sales (000)	6497.0	6668.3	**6643.9**	**−19.3**	7400.0	5566.7	6000.5	6922.2	**6472.4**	**−2.6**	7043.6	6477.3
Corporate Pre-Tax Profits	237.6	249.5	**245.5**	**−3.8**	259.1	229.9	209.8	221.5	**230.1**	**−6.3**	221.8	231.5
− Taxes	78.5	85.2	**82.4**	**−6.0**	91.1	78.9	69.3	73.8	**78.3**	**−4.9**	73.7	77.6
Net Profits	159.1	164.3	**163.2**	**−2.7**	168.0	151.0	140.5	147.7	**151.8**	**−7.0**	148.1	153.9
− Dividend Payments	56.7	57.7	**56.0**	**11.7**	59.6	62.0	63.9	65.9	**62.8**	**12.2**	67.7	69.5
Undistributed Profits	102.4	106.6	**107.2**	**−8.9**	108.4	89.0	76.6	81.8	**88.9**	**−17.0**	80.4	84.3
+ Depreciation	160.5	165.4	**158.3**	**13.4**	170.6	175.6	199.3	204.0	**187.4**	**18.4**	211.5	216.7
− Inventory Profits	41.7	48.4	**45.6**	**7.1**	39.2	24.1	22.3	28.7	**28.6**	**−37.4**	33.3	33.2
Net Cash Flow	221.2	223.6	**219.8**	**2.4**	239.8	240.5	253.6	257.2	**247.8**	**12.8**	258.6	267.9

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

SEPTEMBER 1981

Breaking The Gridlock

A gridlock has developed in the financial markets which is not only feeding on itself, but is beginning to affect a growing portion of the U.S. economy. Persistently high interest rates are taking their toll in both the financial and nonfinancial sectors, raising the possibility that the U.S. economy might not break out of its 2½-year period of stagnation anytime soon. Indeed, if there is a breakout, it could very well be on the downside, with business tumbling into another recession.

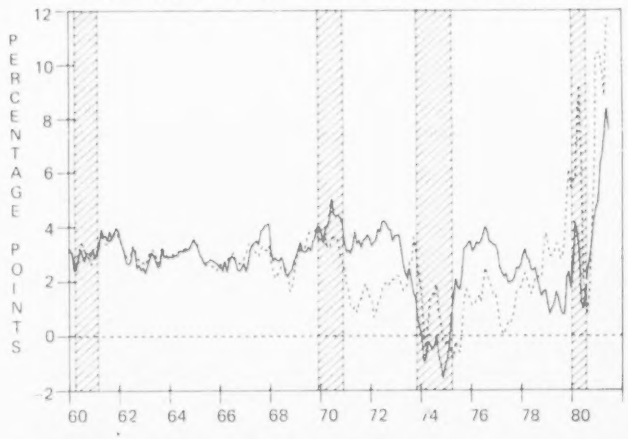
The Fundamentals Suggest Lower Rates . . .

The economic fundamentals certainly would have called for interest rates to decline many months ago. For one thing, the rate of inflation—a key determinant of interest rates—has moderated significantly over the past year. The rate of rise of the consumer price index has slowed from 18 per cent in the first quarter of 1980, to nine per cent since February. Similar slowings have occurred in the personal consumption expenditures deflator and the producer price index. And as you can see from Chart I, until last year, there used to be a pretty close and consistent relationship between inflation and interest rates—both short-term and long-term.

Another economic fundamental that in the past would have produced lower interest rates is economic slack. Not only did the gross national product adjusted for inflation decline in the second calendar quarter of this year, it fell in the second quarter of each of the two previous years, producing a rather lengthy period of relatively little growth. In the past, such reductions in economic activity led to lower interest rates because of the reduced demand for funds as well as the slower rate of inflation noted above.

Even by the monetarist way of looking at things—where the money supply is all-important—interest rates should be down. The money supply MI-B is growing very slowly so far this year. Its year-to-date growth of 4½ per cent has fallen well below the Federal Reserve's minimum objective of six per cent per year

CHART I
SPREAD BETWEEN AA UTILITY RATE AND INFLATION RATE (LINE) AND SPREAD BETWEEN PRIME RATE AND INFLATION RATE (DOT)



between fourth-quarter 1980 and fourth-quarter 1981 (see Chart III, Page 3). In the past, this would lead the markets to anticipate lower interest rates because they would expect the Federal Reserve to be more generous in providing reserves to the banking system in order to boost money growth.

Speaking of the financial markets, the script called for them to be cheered by passage of the President's economic program. Indeed, according to the "rational expectations" faction in Washington, just the very passage of the President's program was supposed to, in and of itself, produce lower interest rates and a rising stock market—prerequisites to help revitalize the U.S. economy. After all, the Administration's program contains the four items that the financial community has longed for the most: lower taxes, a slimmer budget, less inflation and reduced regulations.

. . . But Rates Have Refused To Fall . . .

In spite of these rather powerful forces, interest rates have remained high. Some of the reasons have been widely mentioned, but some have not, so let me review the causes as I see them. First and foremost, of course, there is widespread skepticism over the shape of the Federal budget. The deficit in the fiscal year drawing to a close is a good example of the

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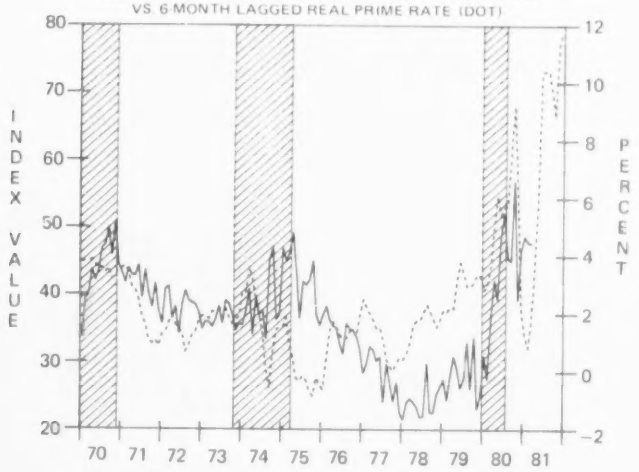
markets' view toward Presidential promises and Congressional actions.

Originally promised by Jimmy Carter to be in balance, the fiscal 1981 budget was subsequently projected by the House-Senate Conference Committee last autumn to be in deficit by $27½ billion. This was soon revised upward to $55½ billion by the Reagan Administration, and to $58 billion by the Congress. But with ten months' data already in, the fiscal year-to-date red ink total already amounts to almost $60 billion. This same upward revision process appears to have affected the budget deficit for fiscal year 1982, while the amount of red ink currently projected for fiscal '83 and beyond also is being revised upward to the point where a balanced budget even by fiscal year 1984 no longer looks likely.

CHART II
INDEX OF BUSINESS FAILURES PER 10,000 FIRMS (LINE)
VS. 6-MONTH LAGGED REAL PRIME RATE (DOT)



The markets are fully aware of the President's determination to balance the budget in order to bring down inflation. However, in view of past history, the markets apparently want to see actual reductions in Federal expenditures and not just promises. To make matters worse, while past Administrations have tended to underestimate spending—there is a good possibility that the Reagan Administration is overestimating revenues, too. Besides the immediate revenue losses that will result from the Administration's economic program, there is the indexing provision scheduled to begin in 1985. Ostensibly passed to protect individuals from the higher taxes that result from inflation pushing them into higher brackets, indexing also deprives the Treasury of billions of dollars in revenues, in effect cutting taxes continually without cutting spending at the same time.

Plainly, the Federal Reserve is playing a key role in keeping interest rates high. By concentrating on the monetary aggregates instead of on financial market conditions, the Fed has made interest rates more unstable than they used to be. This instability, which has caused financial market participants to demand higher rates of return because of the uncertainties associated with monetary policy, its effects on the economy and on the rate of inflation, began in autumn 1979, shortly after the Federal Reserve switched to serious monetarism. Since that time, the month-to-month movement in the key Federal funds rate has averaged approximately seven times the size of the average monthly change in this rate during the previous two years. And ironically, the money supply appears to have grown less smoothly during this time as well.

As a result of the protracted high level of interest rates, a number of Catch 22s have developed which tend to keep interest rates high. For example, high interest rates hurt economic growth and yield less tax revenues for Washington. At the same time, high interest rates boost government spending (approximately $2½ billion per year for each interest rate point). The result is to widen the deficit which, of course, is one of the reasons why interest rates are high in the first place! Another Catch 22 deals with the financial markets. High interest rates depress the stock market, which makes more companies candidates for takeovers, thus boosting loan demand. Strong loan demand keeps interest rates high, too. Finally, high interest rates have caused a shift in corporate borrowing from the long-term markets to the short-term markets as businessmen wait for rates to come down. But this very shift has kept interest rates in the short-term markets high because of supply and demand. As long as short-term rates remain high, long-term rates stay up as well as bond dealers seek to minimize the cost of borrowing to purchase these bonds (see Chart IV, Page 4).

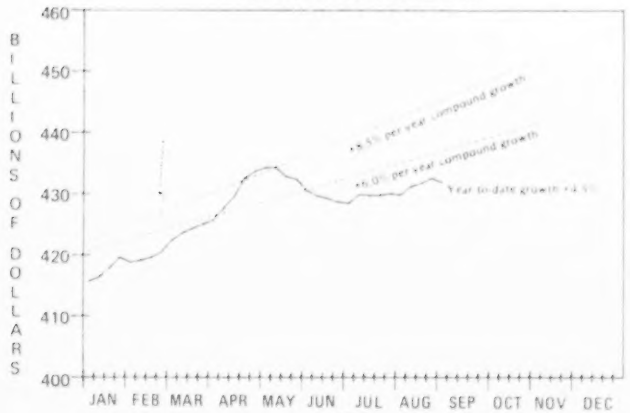
. . . Causing Considerable Pain . . .

Needless to say, these continuously high interest rates are causing considerable pain. As you can see from Chart II, business failures are rising rapidly. And since there appears to be a six-month lag between a change in interest rates adjusted for inflation and the time when companies feel their full impact, you can see where even further increases in bankruptcies are likely. Although concentrated in such well-known interest-sensitive sectors as automobiles and homebuilding, corporate casualties are beginning to occur in a number of other industries, both related and unrelated to these two key sectors. For example, many mutual savings banks and savings and loan associations are in deep trouble because of high interest rates while the nation's farmers are increasingly threatened by the vicious combination of high money costs and low prices for most farm commodities.

There is other pain as well. The Commerce Department reported this month that businesses not only did not step up their plans to invest in new plants and equipment as a result of the passage of the President's economic program—they actually cut

them back over the summer. Along with reduced levels of inventory building, this will keep industry from expanding capacity and jobs as the Administration had hoped. Of course, many holders of financial market instruments have been hurt by the plunge in prices of both equities and fixed-income investments.

CHART III
MONEY SUPPLY, M1-B
FOUR WEEK MOVING AVERAGE



. . . And Warnings From Washington

Not surprisingly, the failure of interest rates to come down has provoked negative reactions from Washington. Several key Administration officials — including the President, himself — have said that interest rates are too high, they are hurting and they ought to come down. Earlier this month some Congressional leaders threatened to seek new restrictions on the financial markets, such as credit controls and a windfall profits tax on interest rates as a means of cajoling the financial markets to lower money costs. There was also a suggestion to modify the independence of the Federal Reserve.

There is much irony in this latest turn of events. This is because this Administration and many of its colleagues in the Congress are supposedly champions of free markets. They should know better than to try to influence the markets by words rather than deeds — especially since it has been the actions of past Administrations and past Congresses in failing to observe the rules of fiscal prudence and economics by running large and continuous deficits in the Federal budget that have been responsible for our current plight.

The Fed Should Ease . . .

Nevertheless, this gridlock in the financial markets must be broken. There has to be a way of bringing interest rates down relatively quickly. Because of repeated disappointments over promises by various Administrations and the Congress, the markets are unlikely to be assuaged anytime soon—unless President Reagan slashes the budget deeply. As I noted before, fiscal year 1981 is drawing to a close much more deeply in deficit than Washington originally estimated, while the same process of underestimating the flow of red ink appears to be well underway for fiscal years 1982 and beyond. Even if the President makes additional cuts in the budget, it will be some time before the markets will be able to determine whether or not these cuts have succeeded in bringing down the deficit.

Until fiscal policy is shaped up, the Federal Reserve must step in to provide at least partial relief by easing monetary policy. To be sure, the Fed has already loosened somewhat its grip on the credit reins. The key Federal funds rate — which may no longer be an objective of Fed policy but certainly reflects it — has come down from 20 per cent in July to 15½ per cent by mid-September. The Fed has accomplished this by making reserves more available to the banking network. Adjusted nonborrowed reserves have increased at a six per cent annual rate since June, after falling at an 11 per cent annual rate from March. It has shown up in the behavior of the money supply MI-B. Reflecting the earlier tightening in nonborrowed reserves, MI-B fell from April to June; it has since gone up, but so slightly that most people have not been aware of it. I think the Fed must be bolder. However, it can do so only with proper justification. Otherwise, as I said in the July Economic Report, any decline in interest rates would only be temporary and would be followed by even higher rates of interest as inflation psychology reached a new higher level.

M-2 AND SELECTED COMPONENTS

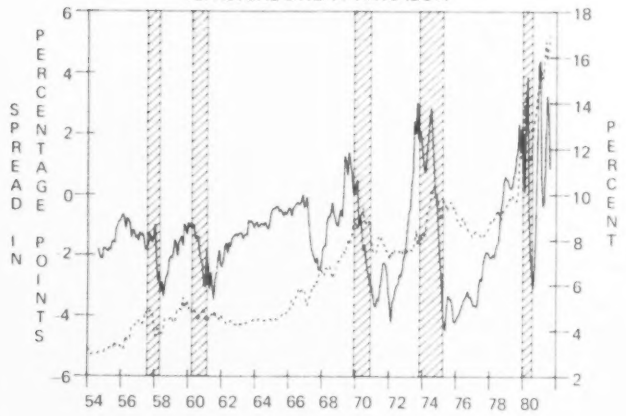
(billions of dollars)

	Dec 1980	% of Total	July 1981	% of Total	Dec-July % Change
M-2 Total	1,669.4	100.0	1,760.0	100.0	+ 5.4
Currency	116.1	7.0	120.9	6.9	+ 4.1
Demand Deposits	267.4	16.0	236.6	13.4	− 11.5
Other Checkable Deposits (NOW Accounts)	28.1	1.7	69.0	3.9	+ 145.6
Money Market Mutual Funds	75.8	4.5	134.3	7.6	+ 77.2
Savings Deposits	393.0	23.5	349.0	19.8	− 11.2
Small-denomination Time Deposits	756.8	45.3	811.6	46.1	+ 7.2

I think I can provide the justification. For the past few months, the Federal Reserve has shifted its focus from the narrowly defined money supply MI-B to two broader definitions: M-2 and M-3. The money managers apparently believe that MI-B understates the amounts of transactions funds available in the system in view of the growth of money market mutual funds, overnight repurchase agreements and other instruments which are not part of MI-B. But no one knows how much of M-2 and M-3 represents transactions balances and how much represents savings which are unlikely to be tapped on a daily basis. The fact that there is widespread speculation that the money market mutual funds will be the big losers when the All

Savers accounts take effect October 1 suggests that this component, which as you can see from the table has contributed significantly to M-2 growth this year, might very well consist largely of savings-type deposits. This is because funds put into All Savers certificates must be left untouched for one year.

CHART IV
SPREAD BETWEEN FEDERAL FUNDS RATE
AND AA UTILITY RATE (LINE)
VS. ACTUAL UTILITY RATE (DOT)



. . . To Break The Gridlock

Because of these and other uncertainties, I think the Fed should shift its focus back to MI-B as an instrument of monetary policy and justify it to the marketplace. The justification is simple: MI-B is the best measure of transactions funds in the economy and, as Chart III demonstrates, it is plainly growing too slowly. Because of this, there is an insufficiency of credit to provide enough funds to cover both Washington's budget deficit and economic growth. Since Washington always gets the funds it needs, economic growth is being shunted aside with the consequences I noted above. Whether right or wrong, the financial markets are monetarist-oriented, so any easing of Fed policy must be acceptable to this belief.

If the Fed eases further, the Federal funds rate would come down even more. In turn, this would enable the banks to reduce both their prime and broker loan rates. As the spread between these rates and the rate on bonds turns positive, long-term rates will start falling. Dealers will be less reluctant to accept lower interest rates on bonds they purchase with borrowed money if the interest rates they have to pay on the funds they borrow is equal to or less than the yield they obtain from the bonds, while investors will be attracted by the higher yields.

Once long-term interest rates begin to fall, some of the loan demand now concentrated in the banks or the commercial paper market should begin to shift back to the bond market. Business might seek to "capture" the lower bond interest rates before they disappear as was the case last year. However, at the same time, investment funds may very well move into the bond markets to "lock up" interest rates while they are still high. While under other circumstances these two developments could produce a standoff, continued easing by the Fed until MI-B is within the target bands, along with a tighter fiscal policy should produce further declines in interest rates, both short and long, with the result that the gridlock will be broken.

Some may regard this approach as tricky while others would look upon it as far-fetched. My response would be to paraphrase the remarks of the great entertainer Maurice Chevalier: It ". . . isn't so bad when you consider the alternatives."

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MANUFACTURERS HANOVER

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

OCTOBER 1981

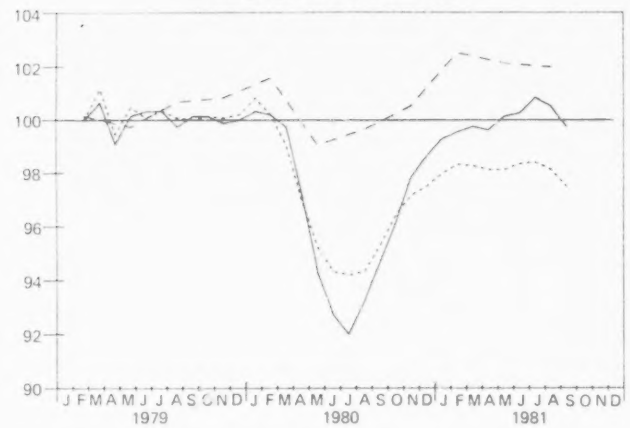
Economic Forecast For 1982

The stagnation that has characterized the U.S. economy since early 1979 has taken a new turn. Whereas business activity rebounded in mid-1979 and mid-1980 following declines in each year's second quarter, it has apparently failed to do so in 1981. After falling at an annual rate of 1-1½ per cent in the second quarter, the gross national product adjusted for inflation fell one half of one percent at annual rates in the third, according to the Commerce Department's preliminary estimates. What is more, since the various monthly and weekly statistics indicate that business activity was weaker at the conclusion of the third quarter than it was at the beginning, it is very likely that yet another decline will occur during the current calendar quarter.

This negative turn of events has prompted a Presidential declaration of recession. In a statement reminiscent of one that Jimmy Carter made back in July of 1979, President Reagan earlier this month voiced his belief that the economy has entered into a recession. Like President Carter's statement, President Reagan's remark is a most unusual admission from an incumbent Administration. Previously, Administrations did not like to talk about recessions—even after they were officially certified by the umpire of the business cycle, the National Bureau of Economic Research. The Bureau has made no such judgment about the most recent decline in economic activity. Indeed, it took the NBER until July of this year to fix the terminal date of last year's recession.

At the risk of being repetitive, I think that the NBER should reconsider its method of dating the business cycle. As I pointed out in the July Economic Report, many consumers and businessmen in the "real world" believe that the recession got under way in early 1979—and is still with us. Certainly, the aggregate measures of economic activity depicted in Chart I would seem to bear this out. The real GNP is only a touch higher today than it was in first-quarter 1979 while industrial production and the coincident indicator index are lower. Plainly, we have been experiencing over much of the

CHART I
REAL GNP (DASH), INDUSTRIAL PRODUCTION (LINE), INDEX OF COINCIDENT INDICATORS (DOT)
FIRST QUARTER 1979 = 100



past three years a definite departure from the business cycles of the past. Since early 1979 the economy has encountered a series of stops and starts, rather than regular, clearly-defined ups and downs in economic activity with their usual effects on interest rates, the rate of inflation and so on.

Given this new environment, it is hardly surprising that economists have had great difficulty in forecasting. Traditional business cycle analysis no longer offers clues to the longevity of a slump or an expansion. Interest rate forecasting—a hazardous undertaking under the best of circumstances—has become virtually impossible without clearly-defined business cycles, not to mention the advent of Federal Reserve's new regime of monetarism. The net result is confusion in the money and credit markets, as well as on the part of consumers, businessmen and policymakers.

The New Energy Equation

What caused this to happen? Why, after decades of regular cyclical ups and downs has the economic rhythm changed? The way I see it, three major developments are responsible. The first has its roots back in 1973-74, when the Organization of Petroleum Exporting Countries slapped an embargo on exports of petroleum to the West, and raised oil prices significantly. Although consumers and business soon adapted to higher-priced

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energy by purchasing smaller cars, insulating their homes and offices, and changing thermostat settings, their enthusiasm for conservation gradually waned as the nominal price of oil held steady in the wake of continued inflation, thereby driving down oil's "real" price.

It took the second "oil shock" of early 1979, that followed in the wake of the revolution in Iran, to change permanently attitudes toward energy use. Those changes resulted in a shift in the basic structure of the U.S. economy. Industries that either used large amounts of energy in the production process or which produced goods that used large amounts of energy soon found themselves in difficulty. Autos were among the first to be affected as consumers sought smaller, energy-efficient vehicles that Detroit was not yet equipped to produce. As a result, those industries that depended heavily on automobiles—the so-called smokestack industries such as steel, copper, rubber, etc.—began to suffer a decline in orders and shipments. Housing was the next to be affected because the increase in energy prices made the cost of running a home significantly higher than in the past, pricing some people out of the market.

On the other hand, industries that either used relatively little energy in the production process or, more importantly, were engaged in the exploration, production, transmission or saving of energy found their fortunes much improved. In other words—the U.S. economy became highly segmented, no longer moving as a monolith, with all industries expanding during good times and contracting during bad times. The economy was able to bounce back from the decline in second-quarter 1979 because the pluses outweighed the minuses. However, overall growth soon slowed down.

Monetarism Becomes a Factor

The next development approached center stage in October, 1979. This was the Federal Reserve's break from its traditional method of conducting monetary policy. Previously, the Fed focused on attempting to stabilize money market conditions by regulating short-term interest rates. In the process, however, it accommodated inflationary shocks to the economy by producing more money than was consistent with real economic growth. This, in turn, led to ever-higher rates of inflation as the economy emerged from the various postwar business cycles, along with ever-higher interest rates. In October, 1979 the Fed began to pay more attention to the money supply and less to money market conditions. It was expected that this monetarist type of monetary policy would result in more fluctuations in day-to-day levels of interest rates. This is because regulating the supply of money without taking into account changes in demand would produce fluctuations in its price in the same way that regulating the price of money by accommodating changes in demand resulted in fluctuations in growth of its supply.

No one was prepared for the amount of volatility that actually occurred in interest rates—especially at the short-term end. Since October, 1979, the month-to-month movement in the key Federal funds rate has averaged approximately seven times the size of the average monthly change in this rate during the previous two years. Because financial market participants became so uncertain over the cost of money, hence their ability to generate a profit on a bank loan, securities investment, etc., they tended to demand higher interest rates to compensate. This spilled over into the long-term markets for reasons I explained in the September Economic Report. And as rates rose in the long-term markets, corporate financing tended to dry up. This, along with the high cost of money for those that did borrow in the bond markets discouraged business investment, leading to declines in another wave of industries—those dealing with capital goods. Needless to say, high short-term rates once again affected the housing and automobile sectors, sending them down in early 1980 for the second time in two years.

For a while, most companies were able to adapt to these circumstances because the "real" cost of borrowing was negligible. Monetarism notwithstanding, nominal interest rates were barely above the rate of inflation in the opening months of 1980—and plunged well below the rate of inflation in the wake of the steep decline in economic activity in last year's second quarter and the Fed's effort to arrest this by injecting reserves into the banking system. This was subsequently followed by a rise in interest rates as the Fed sought to reverse the rise in money growth that followed.

Interest rates remained high through the beginning of 1981 even though the rate of inflation had begun to slow under the pressure of a slower-growth economy, flatness and eventual decline in oil prices, and falling prices of food and industrial commodities. This resulted in a rise in the "real" cost of borrowing money to levels not seen in recent memory. The belief that adhering to monetarism would eventually bring lower rates of inflation and interest, along with the hoped-for positive results of the Administration's planned economic program encouraged people to overlook these high real costs of borrowing money. Unfortunately, many found that they could not—witness the 40 percent jump in business failures thus far in 1981.

Fiscal Policy Pushes Business Down

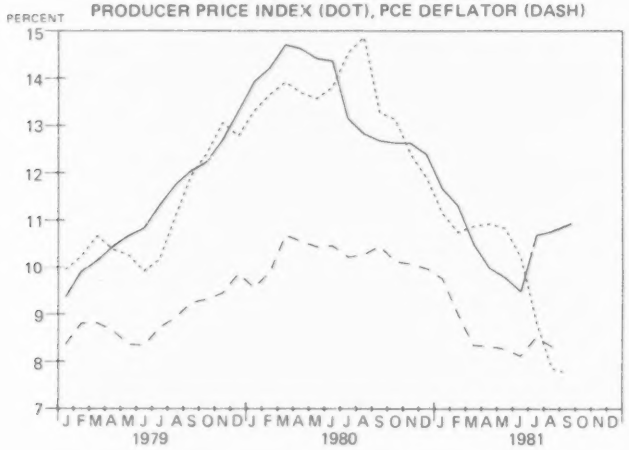
The economy thus managed to adapt to monetarism as well. After falling sharply in second-quarter 1980, the aggregate measures of business activity subsequently bounced back. However, the third development, the Administration's fiscal program, was apparently too much for the economy to bear. This is ironic, because it was intended to improve business. The cuts in personal and business taxes engineered by the White House were supposed to boost expectations, stimulate savings, and encourage business investment in new plants and equipment. Accompanied by significant increases in defense spending, with only belated cuts in nondefense spending, this provided a hefty dose of fiscal stimulus

to the economy. It was supposed to generate optimism on Wall Street as well as Main Street, but when people got down to the arithmetic, they concluded that it could not work.

Cutting taxes and increasing defense spending before putting into effect offsetting reductions in nondefense outlays amounted to a substantial widening of the budget deficit—regardless of what their classroom results might have suggested. Since the Federal Reserve has adapted a policy of trying to slow the growth of the money supply to noninflationary proportions, Washington's increased financing needs could only come at the expense of funds available to the private sector. Total Federal borrowing, direct and guaranteed, has already risen at a substantial rate over the years, accounting for a bigger and bigger share of all the funds raised in the financial markets. The belief that this trend will continue finally put the kibosh on economic activity, preventing business from recovering from this year's downturn.

The road ahead looks equally rocky. It will take a long time for the economy to adjust fully to the changed energy environment. Until it does, those industries that have been negatively affected by the sudden jump in the price of energy will continue to be so. More important, the combination of a loose fiscal policy and a tight monetary policy will prevent the private sector from mounting any kind of a sustained, healthy recovery.

CHART II
12-MONTH PERCENT CHANGE IN
CONSUMER PRICE INDEX (LINE),
PRODUCER PRICE INDEX (DOT), PCE DEFLATOR (DASH)



There is one bright spot, however, and that is the prospect for a further improvement in the rate of inflation. As you can see from Chart II, the three major price indexes have decelerated noticeably from their early 1980 highs. The pain of economic slump, by making it more difficult for business to raise prices and labor to raise wages, will ensure a further slowing in the rate of inflation.

The more financial participants see inflation dampened, the more likely they are to believe that it is "permanent" and the sooner interest rates will come down. While there is always the possibility that huge Federal financings will interrupt this decline and push rates up for a while, I don't look for rates to rise to new record highs. This is not necessarily because I have any great faith in the ability of Washington to get its budget deficit down. Rather, I feel that interest rates at present levels are already proving onerous to the private sector and, unless accompanied by a sudden turnaround in inflation, any increase would simply cause more companies to go under, thereby reducing the demand for funds and offsetting the increased pressure from the Federal government.

Recommendations

In the July Economic Report, I called for a tightening of fiscal policy to reduce the pressure on the money and credit markets without the Fed resorting to monetary ease. Events of the last three months suggest that such a development is more important than ever. I think the Administration should postpone the second-stage tax cut now scheduled to take effect July 1, 1982. What is more, I think other sources of revenue should be looked for, including a value added tax. I think the Administration should be more realistic about how much it is going to get in the way of further cuts in nondefense spending while defense spending is permitted to grow. I do believe in tax incentives to encourage business investment, but at the moment these should be limited to those dealing with new energy-saving machines, processes, etc.

On the monetary side, I think the Fed should continue its recent move toward somewhat easier money. This is not to say that its growth targets for the various money and credit aggregates should be elevated. Rather, in the case of the money supply M1-B, the Fed should try to get this aggregate to grow a little faster, so that it will be within the target range, rather than below it.

It is clear that a loose fiscal policy combined with tight money can only serve to depress economic activity and not the reverse. No matter what incentives may be written into the tax law for individual saving and business investment, when the Federal government crowds out the private sector by driving interest rates up, throwing businesses into the bankruptcy courts and individuals out of work, it is clear that neither will take place.

Perhaps the time has come to try the opposite—that is, a tight fiscal policy and a *relatively* easy monetary policy. This will reduce the pressure on the credit markets coming from Washington while at the same time making more funds available for individuals and business to use in their buying and investment decisions. Provided that the Fed doesn't go overboard with growth in money, I think this might lead to a healthier economy. There will be plenty of time to talk about reducing tax burdens once the budget gets into balance and stays there. For the moment, however, cutting the budget deficit must be the first priority and it must be done quickly. H

October, 1981

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

	< ACTUAL					PROJECTED >								
	YEAR 1980		1981				YEAR 1981		1982				YEAR 1982	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2626.1**	**8.8**	2853.0	2885.8	2947.0	3003.0	**2922.2**	**11.3**	3055.7	3121.1	3195.9	3266.4	**3159.8**	**8.1**
GNP: $72	**1480.7**	**−0.2**	1516.4	1510.4	1508.2	1500.7	**1508.9**	**1.9**	1500.8	1507.8	1515.3	1519.0	**1510.7**	**0.1**
% Change, Annual Rates	**−0.2**		8.6	−1.6	−0.6	−2.0	**1.9**		0.0	1.9	2.0	1.0	**0.1**	
Consumption	**1672.7**	**10.7**	1810.1	1829.1	1888.6	1937.7	**1866.4**	**11.6**	1978.2	2020.8	2066.5	2116.3	**2045.5**	**9.6**
Durables	**211.9**	**−0.2**	238.3	227.3	240.0	246.2	**237.9**	**12.3**	249.7	256.2	259.3	269.1	**258.6**	**8.7**
Non-Durables	**675.7**	**12.2**	726.0	735.3	750.1	763.2	**743.6**	**10.1**	774.8	787.9	806.8	820.6	**797.5**	**7.2**
Services	**785.2**	**12.8**	845.8	866.5	898.6	928.3	**884.8**	**12.7**	953.7	976.7	1000.4	1026.5	**989.3**	**11.8**
Investment	**395.3**	**−4.9**	437.1	458.6	449.8	435.9	**445.4**	**12.7**	439.0	459.4	478.1	486.6	**465.8**	**4.6**
Non-Residential	**295.9**	**5.8**	315.9	324.6	330.8	332.9	**326.1**	**10.2**	336.4	342.6	348.8	353.0	**345.2**	**5.9**
Producers Durable Equipment	**187.1**	**2.0**	198.7	201.5	203.1	203.1	**201.6**	**7.7**	205.0	209.7	214.0	216.0	**211.2**	**4.8**
Structures	**108.8**	**13.0**	117.2	123.1	127.8	129.9	**124.5**	**14.4**	131.4	132.9	134.8	137.0	**134.0**	**7.6**
Residential	**105.3**	**−11.2**	116.7	110.7	101.4	99.2	**107.0**	**1.7**	103.7	107.8	118.9	122.1	**113.1**	**5.7**
Inventory Changes	**−5.9**		4.5	23.3	17.6	3.8	**12.3**		−1.1	8.9	10.5	11.5	**7.4**	
Net Exports	**23.3**		29.2	20.8	18.0	17.3	**21.3**		14.3	9.9	7.9	11.3	**10.9**	
Government Purchases	**534.7**	**12.9**	576.5	577.4	590.5	612.1	**589.1**	**10.2**	624.1	631.0	643.4	652.2	**637.7**	**8.2**
Federal Defense	**131.7**	**18.4**	145.2	148.2	154.6	168.4	**154.1**	**17.0**	172.7	174.9	178.2	180.0	**176.5**	**14.5**
Federal Civilian	**67.2**	**18.5**	76.4	71.3	73.0	74.5	**73.8**	**9.8**	76.3	78.1	76.9	75.7	**76.7**	**4.0**
State & Local	**335.8**	**9.8**	354.9	357.9	362.9	369.2	**361.2**	**7.6**	375.1	378.0	388.3	396.5	**384.5**	**6.4**
Final Sales: $72	**1483.6**	**0.7**	1517.8	1499.6	1497.9	1499.1	**1503.6**	**1.3**	1501.4	1504.0	1511.0	1514.3	**1507.7**	**0.3**
% Change, Annual Rates	**0.7**		6.9	−4.7	−0.5	0.3	**1.3**		0.6	0.7	1.9	0.9	**0.3**	
GNP Price Index (1972 = 100)	**177.4**	**9.0**	188.1	191.1	195.4	200.1	**193.7**	**9.2**	203.6	207.0	210.9	215.0	**209.1**	**8.0**
% Change, Annual Rates	**9.0**		9.8	6.4	9.4	10.0	**9.2**		7.2	6.8	7.7	8.1	**8.0**	
PCE Deflator (1972 = 100)	**178.9**	**10.2**	188.5	191.5	195.7	199.5	**193.8**	**8.3**	203.1	206.5	210.4	213.8	**208.4**	**7.6**
% Change, Annual Rates	**10.2**		8.0	6.5	9.1	7.9	**8.3**		7.5	6.9	7.7	6.7	**7.6**	
Consumer Price Index (1967 = 100)	**247.0**	**13.5**	263.6	268.4	276.1	283.2	**272.8**	**10.5**	287.7	292.8	298.6	303.8	**295.7**	**8.4**
% Change, Annual Rates	**13.5**		10.8	7.5	11.9	10.7	**10.5**		6.4	7.3	8.2	7.1	**8.4**	
Total Personal Income	**2160.3**	**11.1**	2319.7	2368.5	2440.0	2513.7	**2410.5**	**11.6**	2561.1	2610.4	2676.3	2728.4	**2644.0**	**9.7**
Disposable Personal Income	**1821.7**	**11.0**	1947.8	1985.6	2040.1	2099.1	**2018.1**	**10.8**	2137.2	2175.1	2259.9	2300.5	**2218.2**	**9.9**
Savings Rate	**5.6**		4.6	5.4	4.9	5.2	**5.0**		5.0	4.6	6.1	5.6	**5.3**	
Employment Rate	**57.7**		57.7	58.0	57.7	57.4	**57.7**		57.3	57.6	57.8	58.0	**57.7**	
Unemployment Rate	**7.1**		7.3	7.4	7.2	7.9	**7.5**		8.3	8.0	8.1	8.1	**8.1**	
Indus. Production (1967 = 100)	**147.0**	**−3.6**	151.8	152.5	153.1	150.6	**152.0**	**3.4**	150.0	151.5	152.7	152.2	**151.6**	**−0.3**
Housing Starts (000)	**1303.5**	**−24.0**	1390.7	1176.3	966.3	952.1	**1121.4**	**−14.0**	1154.5	1222.5	1323.8	1195.6	**1224.1**	**9.2**
Domestic Auto Sales (000)	**6629.1**	**−19.5**	7400.0	5566.7	6933.3	6309.8	**6552.4**	**−1.2**	6730.6	7136.4	7147.5	7273.6	**7072.0**	**7.9**
Corporate Pre-Tax Profits	**245.5**	**−3.8**	257.0	229.0	215.0	211.4	**228.1**	**−7.1**	209.6	218.8	224.0	227.3	**219.9**	**−3.6**
− Taxes	**82.4**	**−3.0**	87.7	76.4	69.4	68.2	**75.4**	**−8.4**	67.1	70.4	72.2	73.4	**70.8**	**−6.2**
Net Profits	**163.2**	**−2.7**	169.2	152.7	145.6	143.2	**152.7**	**−6.5**	142.5	148.3	151.8	154.0	**149.2**	**−2.3**
− Dividend Payments	**56.0**	**11.7**	59.6	62.0	64.8	66.6	**63.3**	**13.0**	67.8	68.7	70.4	73.0	**70.0**	**10.6**
Undistributed Profits	**107.2**	**−8.9**	109.6	90.6	80.8	76.5	**89.4**	**−16.6**	74.7	79.6	81.4	81.0	**79.2**	**−11.4**
+ Depreciation	**158.3**	**13.4**	172.8	179.9	187.2	192.4	**183.1**	**15.7**	202.5	205.5	208.6	212.1	**207.1**	**13.1**
− Inventory Profits	**45.6**	**7.1**	39.2	24.0	27.2	20.9	**27.8**	**−39.0**	27.7	33.3	34.6	30.7	**31.6**	**13.4**
Net Cash Flow	**219.8**	**2.4**	243.2	246.5	240.8	248.0	**244.6**	**11.3**	249.4	251.8	255.4	262.4	**254.8**	**4.1**